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Letter in Re: File No. S7-527: Capitalization of Interest by Companies Other Than Public Utilities

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American Institute of Certified Public Accountants

666 Fifth Avenue, New York, New York 10019 (212) 581-8440

August 30, 1974

Mr. George A. Fitzsimmons,
Secretary
Securities and Exchange Commission
Washington, D. C. 20549

Re: File No. S7-527; Capitalization
of Interest by Companies Other
Than Public Utilities

Dear Mr. Fitzsimmons:

This letter is submitted by the Accounting Standards Division of the American Institute of Certified Public Accountants in response to the request for comments on the proposed action of the SEC regarding capitalization of interest.

In view of the broad theoretical implications and the implementation difficulties of the proposed release, we urge that (1) the proposal not be adopted as presently set forth, (2) the issue be referred to the Financial Accounting Standards Board for its study and recommendations, and (3) awaiting FASB action, the Commission adopt disclosure requirements (1) and (2) as contained in the proposed release subject to certain modifications. The rationale for this position is set forth in the following paragraphs.

Theoretical Implications

The capitalization of interest on major projects under construction has existed for some years as an acceptable alternative accounting practice. It has been accepted on the grounds of improving the matching of costs with the revenues derived from the project, and is comparable to the treatment commonly given to real estate taxes and insurance premiums under similar circumstances. The proposed release does not provide a rationale for abandoning this alternative practice.

Indeed, we believe the broader aspects of the issue, including consideration of whether interest on debt and/or equity capital is a proper asset cost component, merits careful study. We cite the June 21, 1974 release by the Cost Accounting Standards Board of a staff paper concerning cost of contractor capital as additional evidence of the need for study on a comprehensive basis.

Furthermore, two AICPA industry guides (Audits of Savings and Loan Associations and Accounting for Retail Land Sales) specifically accept interest capitalization. With respect to real estate owned by savings and loan associations where current sale is unlikely or there is an intent to hold or develop the property over an extended period, capitalization of "amounts representing the cost of money... invested in the property (discount factor)" is recommended. In retail land sales companies, interest capitalization is permissible ("Interest is properly capitalizable ...") until land is improved into a saleable condition. As written, the SEC proposal would preclude the adoption of interest capitalization by newly-created savings and loan institutions and newly-created retail land development companies, or a change by existing companies to the capitalization method which is specifically acknowledged as accepted in authoritative literature.

We also note that in the maritime industry a substantial number of companies operate under certain provisions of the Merchant Marine Act of 1936 and in accordance with General Order 24 of the Maritime Administration, which requires the capitalization of interest. As a minimum, the proposed SEC release would preclude companies first investing in vessels after June 21, 1974 from following the accepted industry practice, and could also create difficulties for those companies, already following General Order 24, which have not made a specific public disclosure to that effect.

Additionally, in certain areas of health care (Medicare, Medicaid and other third party reimbursements) the programs provide for capitalization of interest.

The proposed release would, of course, apply to all registrants and, consequently, there would be no consistency of treatment among companies under Commission jurisdiction. Indeed, rather than establishing a dual standard, a manifold standard would be created because

the proposal exempts certain utilities, permits continuation of interest capitalization where it has been established, and yet does not permit extension to "new types of assets."

Furthermore, at the time the SEC, in ASR 145, "froze" the subsequent adoption of catastrophe reserves by property and casualty insurance companies, that action was effected near the inception of the practice by a relatively few companies, rather than after the practice had been in use for some years by a large number of companies as is the case with interest capitalization.

Specific Comments on Release

With respect to the requirements set forth in the proposed release, there appear to be several difficulties:

1. The definition of companies excluded from the requirements of the release (electric, gas and water utilities) does not recognize other enterprises where, as stated in the Addendum to APB Opinion 2, "... it is clear that ... costs will be recoverable out of future revenues ..." We believe the distinctions set forth in the Addendum are superior to the specific description of certain industries as given in the proposed release.
2. The proposed release would prohibit extension of interest capitalization applied earlier to "new types of assets." The absence of a definition of "new types of assets" is likely to raise problems in the application of the release. The following examples suggest possible difficulties:
 - a) A conglomerate has capitalized interest for a domestic chemical plant under construction; may it do so for a foreign steel mill?
 - b) A company building single-family residences has capitalized interest; may it do so if it constructs apartment buildings?
 - c) A company holding land for retail development has capitalized interest; may it do so with respect to condominiums it constructs on the land?

3. The proposed release would prohibit adoption by non-utility companies which had not "publicly disclosed (such) an accounting policy ..." as of June 21, 1974. This provision raises questions as to (1) what would constitute adequate public disclosure of the policy in advance of June 22, and (2) the extent to which this proposed requirement as literally stated may be avoided if prior capitalization had been immaterial and therefore not disclosed in earlier periods, yet is material in the current period as applied to the same type of asset.

The following examples suggest possible situations where interest capitalization may be precluded inequitably, or where it may be difficult to determine the applicability of the release:

- a) a company existing prior to June 21, 1974 has its first SEC registration subsequent to June 21, 1974; what standard is to be applied in this instance?
- b) a company has an investment in an investee company, not subject to the SEC, which begins capitalizing interest after June 21, 1974; would the proposed release apply to this situation? Or, if the investee is subject to the SEC, what is the criteria for public disclosure on the part of either the investor or the investee with respect to a pre-existing policy of interest capitalization?

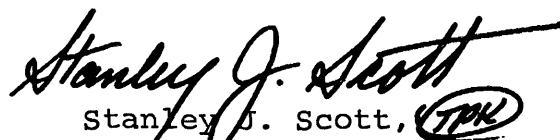

Recommendations for Disclosure

In recognition of the broader aspects of the issue deserving further consideration and the specific difficulties arising in the implementation of the proposal, we recommend adoption of only disclosure requirements (1) and (2). It is our belief that disclosure requirement (1), in addition, deserves modification to permit the disclosure of capitalized interest to be given in footnotes; as presently written, disclosure "within the income statement," would apparently require disclosure on the face of the income statement.

As indicated in earlier letters to the Commission, it is our view generally that the presentation of supplemental financial information determined on the basis of alternative accounting practices is not of demonstrated utility to the users of financial statements, and in case of capitalized interest, such data may not be readily obtainable. Consequently, we urge that disclosure requirements (3) and (4) not be adopted.

After you have had an opportunity to consider these recommendations, representatives of the Division would be willing to meet with you to discuss our views further should you wish to do so.

Very truly yours,


Stanley J. Scott, 
Chairman
ACCOUNTING STANDARDS
DIVISION